



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.31/2000-10

11 August 2000
00-PAC-071(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Recent Cost Accounting Standards (CAS) Rules

SUMMARY

In June 2000, four separate rules were issued related to cost accounting standards (CAS). The rules include:

- CASB Final Rule on Changes in Cost Accounting Practices, issued June 14, 2000,
- CASB Final Rule on Applicability, Thresholds and Waiver of CAS Coverage, issued June 9, 2000,
- FAR Interim Rule on Applicability, Thresholds and Waiver of CAS Coverage, issued June 6, 2000, and
- DFARS Final Rule on Waiver of CAS, issued June 6, 2000.

The purpose of this memorandum is to provide audit guidance on the rule on Changes in Cost Accounting Practices. We previously provided guidance on the CASB interim rule on applicability, thresholds, and waivers in a Memorandum for Regional Directors (MRD) dated March 31, 2000 (00-PAC-028(R)). Our guidance here summarizes the CASB, FAR, and DFARS final and interim rules on the subject. A flowchart for determining CAS coverage and Disclosure Statement requirements under the revised CAS Board rule is provided as an enclosure.

GUIDANCE

1. CAS Final Rule on Changes in Cost Accounting Practices.

On June 14, 2000, the CASB issued a final rule, effective the same day, on Changes in Cost Accounting Practices (65 FR 37469). The rule concludes the CASB case that began in 1993. The final rule is significantly reduced in scope as compared to earlier proposed rules on this subject because:

- There is a projected decline in CAS-covered contracts (from the changes in CAS applicability and thresholds), and
- It was decided to include rules concerning CAS cost impact administration in the FAR.

The following are the major features of the CASB final rule:

- Clarifies the applicable interest rate to use when recovering increased cost paid as a result of a noncompliance,
- Provides definitions of required, unilateral, and desirable changes to cost accounting practices,
- Expands existing guidance regarding “findings” determinations by the contracting officer,
- Clarifies the aggregate value of contract adjustments for unilateral changes and estimating noncompliances, and
- Includes an exemption from the cost impact process for cost accounting practice changes directly associated with external restructuring activities.

a. Interest rate.

The contract clauses for full and modified coverage (9903.201-4(a), (c), and (e)) are revised to clarify that the applicable interest rate to be applied to payments for noncompliances is the Underpayment Rate established under Section 6621(a)(2) of the Internal Revenue Code. This is the same rate used for postaward audit adjustments and is found at CAM 14-124d. The rule is silent on whether interest should be applied as simple or compound interest; however, we continue to believe that simple interest should be applied, consistent with interest on defective pricing adjustments.

b. Definitions of required, unilateral, and desirable changes to cost accounting practices.

The rule expands the current coverage in 9903.201-6, Findings, to include definitions of required (i.e., mandatory), unilateral (i.e., voluntary), and desirable changes, as follows:

(a)(2) *Required change* means a change in cost accounting practice that a contractor is required to make in order to comply with applicable Standards, modifications, or interpretations thereto, that subsequently become applicable to an existing CAS-covered contract due to the receipt of another CAS-covered contract or subcontract. It also includes a prospective change to a disclosed or established cost accounting practice when the cognizant Federal agency official determines that the former practice was in compliance with applicable CAS and the change is necessary for the contractor to remain in compliance.

(b)(2) *Unilateral change by a contractor* means a change in cost accounting practice from one compliant practice to another compliant practice that a contractor with a CAS-covered contract(s) elects to make that has not been deemed desirable by the cognizant Federal agency official and for which the Government will pay no aggregate increased costs.

(c)(2) *Desirable change* means a compliant change to a contractor's established or disclosed cost accounting practices that the cognizant Federal agency official finds is desirable and not detrimental to the Government and is therefore not subject to the no increased cost prohibition provisions of CAS-covered contracts affected by the change. The cognizant Federal agency official's finding need not be based solely on the cost impact that a proposed practice change will have on a contractor's or subcontractor's current CAS-covered contracts. The change to a cost accounting practice may be determined to be desirable even though existing contract prices and/or cost allowances may increase. The determination that the change to a cost accounting practice is desirable, should be made on a case-by-case basis.

Required Change:

Of particular note is the classification of a prospective accounting practice change necessary to remain in compliance with CAS as a required change. An example of such a change is a labor-intensive contractor that receives several material-intensive contracts. The contractor's total cost input G&A allocation base would cause disproportionate allocations of G&A expense to the material-intensive contracts. Therefore, in order to remain in compliance with CAS 410, the contractor changes to a value-added G&A allocation base. Prior to award of these contracts, the contractor was in compliance with CAS 410. In order to remain in compliance with CAS 410, the contractor must change to a value-added allocation base. This would be considered a required change that would be settled as an equitable adjustment under the Changes Clause of the contract.

Unilateral Change:

Prior to issuance of this rule, the term "voluntary change" was often used to refer to all changes to cost accounting practices except required changes. Therefore, the term, "voluntary change," previously included both desirable changes (which permit payment of an equitable adjustment to settle the cost impact) and other than desirable changes (for which the government will not pay increased costs in the aggregate). The new rule makes a distinction between these two types of changes, using the term "desirable change" for changes deemed desirable by the government, and using the term "unilateral change" for changes in which the government will not pay increased costs in the aggregate. The rule expressly states that until the cognizant Federal agency official

(CFAO) determines that the proposed change is desirable, it is considered a unilateral change for which the government will not pay increased costs in the aggregate (9903.201-6(c)(4)).

Desirable Change:

For desirable changes, the rule states in 9903.201-6(c)(3) that the cost impact of “associated management actions” that have an impact on contract costs should be considered when negotiating contract price or cost adjustments. This means that there may be other events occurring at the same time as the accounting practice change that may need to be considered to equitably resolve the overall cost impact. We believe examples of “associated management actions” include internal restructuring activities.

During an internal restructure, there is usually a reduction in personnel or facilities. When computing the cost impact for *unilateral* cost accounting practice changes, the cost impact of the accounting change would exclude the impact of the reduction in personnel and facilities in order to compute the impact of *only* the cost accounting practice change. In order to achieve this, the same cost baseline would be used to calculate the impact both before and after the change. However, once the CFAO determines that a change is desirable, the cost impact of the reduction in personnel or facilities (or other events associated with the restructuring) should be considered in determining the cost impact of the accounting change.

In order to consider the impact of the organizational changes in the cost impact, the impact should be calculated as the difference between the former accounting practice *using the cost level without the effect of restructuring*, and the new accounting practice *using the new cost estimate* as reflected in the new forward pricing rates. Using these two cost baselines would incorporate the impact of reductions in personnel or facilities that are associated with the restructuring activity.

c. Findings.

Prior to the new rule, section 9903.201-6, Findings, specified that the contracting officer shall make a determination that an accounting change is desirable and not detrimental to the government. The new rule expands this and requires the contracting officer to make specific findings, as applicable:

- That a change to a cost accounting practice is either a required or desirable change, or
- That the planned contract price and cost adjustments for unilateral changes and noncompliances will protect the government from payment of increased costs in the aggregate, and that the net effect of the adjustments does not result in the recovery of more than the estimated increased costs.

d. Aggregate increased costs to the government.

The CAS statute (Pub. L. 100-679) states that the government shall be protected from payment of increased costs in the aggregate for noncompliances and changes to cost accounting practices. The new rule expands on this basic concept for unilateral changes. It states at 9903.201-6(b)(3) that the CFAO must limit upward contract price adjustments on affected contracts to the amount of downward contract price adjustments of other affected contracts, i.e., no net upward contract price adjustments will be permitted. In other words, the total amount of upward contract price adjustments cannot be greater than the total amount of downward contract price adjustments as the result of a unilateral accounting practice change.

Regarding estimating noncompliances, the rule states at 9903.201-6(d) that individual contract prices, including cost ceilings or target costs, may be increased or decreased to resolve an estimating noncompliance, as long as the aggregate value of all contracts affected by the noncompliance is not increased. Estimating noncompliances occur when negotiated contract prices are based on noncompliant accounting practices.

e. Exemption from cost impact process for cost accounting practice changes directly associated with external restructuring activities.

The rule includes an exemption from the cost impact process and contract price and cost adjustment requirements of the CAS clauses for accounting practice changes directly associated with external restructuring activities. This means an accounting practice change that is a direct result of a restructuring activity, and which would not have occurred but for the restructuring activity. The restructuring activities must be subject to and meet the requirements of 10 U.S.C. 2325. This type of restructuring activity is described in CAM 7-1900 and DFARS 231.205-70.

One of the requirements associated with restructuring costs is that audited savings for DoD exceed the costs allowed by a factor of two-to-one, or that savings exceed costs and the Secretary of Defense determines that the restructuring activities will result in the preservation of a critical capability that might otherwise be lost to the Department. Corporate restructuring often involves several changes to cost accounting practices for which the government, prior to the new CASB rule, was entitled to recovery of any increased costs paid. However, since the government is achieving overall cost savings in this type of restructuring effort, the CASB decided to exempt from the cost impact process changes to cost accounting practices directly associated with external restructuring activities.

The following is a hyperlink to the rule:

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=00-14243-filed.pdf

2. CAS Final Rule on Applicability, Thresholds and Waiver of CAS Coverage.

On April 2, 2000, the CAS Board (CASB) issued an interim rule on this subject to incorporate provisions included in the National Defense Authorization Act for FY 2000. The interim rule was effective April 2, 2000.

We previously issued audit guidance on the interim rule in a Memorandum for Regional Directors (MRD), subject: Audit Guidance on Interim Rule – Applicability, Thresholds and Waiver of Cost Accounting Standards Coverage (00-PAC-028(R), dated March 31, 2000). That MRD also included training material, which all auditors should have received by now. The interim rule included the following features:

- Increased the threshold for full CAS coverage and Disclosure Statements from \$25 million to \$50 million,
- Added an exemption from CAS for contracts less than \$7.5 million provided the business unit is not currently performing any CAS-covered contracts greater than \$7.5 million,
- Replaced the previous exemption at 48 CFR 9903.201-1(b)(15) (firm-fixed price (FFP) contracts awarded without any cost data) with an exemption for FFP contracts awarded based on adequate price competition without cost or pricing data, and
- Delegated CAS waiver authority to heads of executive agencies under certain circumstances.

The CASB reviewed the public comments to the interim rule and issued a final rule on June 9, 2000, effective the same date (65 FR 36767). The final rule remains unchanged from the interim rule. However, the CASB Preamble comments clarify the term “currently performing” used in the new 9903.201-1(b)(7) exemption, since several commenters asked for clarification. The new (b)(7) exemption applies to:

Contracts or subcontracts of less than \$7.5 million, provided that, at the time of award, the business unit of the contractor or subcontractor is not currently performing any CAS-covered contracts or subcontracts valued at \$7.5 million or greater.

In its preamble comments, the CASB noted that “currently performing” is already defined in 9903.301, Definitions, as follows:

Currently performing, as used in this part, means that a contractor has been awarded a contract, but has not yet received notification of final acceptance of all supplies, services, and data deliverable under the contract (including options).

Therefore, “currently performing” is intended to reflect the period of time when work is being performed on contractual effort. The period ends when the government notifies the contractor of final acceptance of all items under the contract. If a contractor is currently performing a CAS-covered contract of \$7.5 million or greater, CAS coverage is triggered and new awards are subject to CAS (unless it meets another exemption under 9903.201-1(b)).

As the final rule reflects the same language as the interim rule, our previous audit guidance issued March 31, 2000, remains unchanged.

We have included as an enclosure to this memorandum a flowchart for determining CAS coverage and Disclosure Statement requirements. This flowchart revises CAM Figure 8-1-1, and will appear in the January 2001 version of CAM.

The following is a hyperlink to the rule:

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=00-14242-filed.pdf

3. FAR Interim Rule on Applicability, Thresholds and Waiver of CAS Coverage.

On June 6, 2000, an interim rule was published in the FAR (65 FR 36028) to incorporate into FAR Parts 30 and 52 the CASB’s interim (now final) rule on applicability, thresholds and waiver of CAS coverage (discussed in Item 1 above). The FAR interim rule is effective June 6, 2000, and applies to solicitations issued on or after that date.

In addition to changing FAR references to reflect the increase in full CAS coverage and Disclosure Statement submission from \$25 million to \$50 million, the interim rule includes implementing guidance on CAS waivers in FAR 30.201-5.

As outlined in the CASB’s rule at 9903.201-5, Waivers, FAR 30.201-5 provides that the head of an agency may waive CAS applicability. FAR 2.101 defines “head of an agency” as heads of executive, military, and independent departments. Delegation of waiver authority may not be made lower than the senior contract policymaking level of the agency.

CAS may be waived under two circumstances:

- The contract or subcontract is less than \$15 million, and the segment performing the work is primarily engaged in the sale of commercial items and has no contracts or subcontracts subject to CAS, or

- “Exceptional circumstances” exist whereby a waiver of CAS is necessary to meet the needs of the agency.

The FAR interim rule states that exceptional circumstances exist only when the benefits to be derived from waiving CAS outweigh the risk associated with the waiver. A waiver for exceptional circumstances must be in writing and include a statement of the specific circumstances that justify granting the waiver.

Additionally, the interim FAR rule identifies the information that must be submitted with the waiver request, such as a statement of the specific circumstances that justify granting the waiver, whether the segment(s) that will perform the contract has CAS-covered contracts, and the benefits and risks to the government of waiving CAS. A complete list of documentation required is at FAR 30.201-5(c).

The interim rule on CAS waivers primarily affects procurement personnel requesting CAS waivers, so no further audit guidance is provided for this area. The audit guidance, issued March 31, 2000 (MRD 00-PAC-028(R)), for the CASB rule on applicability, thresholds and waiver of CAS coverage (referenced in Item 1 above) also covers the FAR changes in this interim rule.

The following is a hyperlink to the rule:

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=00-13824-filed.pdf

4. DFARS Final Rule on Waiver of CAS.

This final rule, published and effective June 6, 2000 (65 FR 36034), modifies DFARS 230.201-5 to describe the procedures for DoD departments and contracting activities to follow when waiving CAS.

As discussed in Item 2 above, military departments have CAS waiver authority under FAR 30.201-5. The DFARS rule instructs military departments to submit each CAS waiver request to the Director of Defense Procurement (DDP) for review at least 14 days before granting the waiver. DoD contracting activities that are not within a military department must submit CAS waiver requests to DDP for approval at least 30 days before the anticipated contract award date. The rule also specifies that military departments must not delegate waiver authority below the individual responsible for issuing contracting policy for the department.

The following is a hyperlink to the rule:

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2000_register&docid=00-13828-filed.pdf

CONCLUDING REMARKS

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact Ms. Susan Barajas, Program Manager, Accounting and Cost Principles Division, at (703) 767-3252.

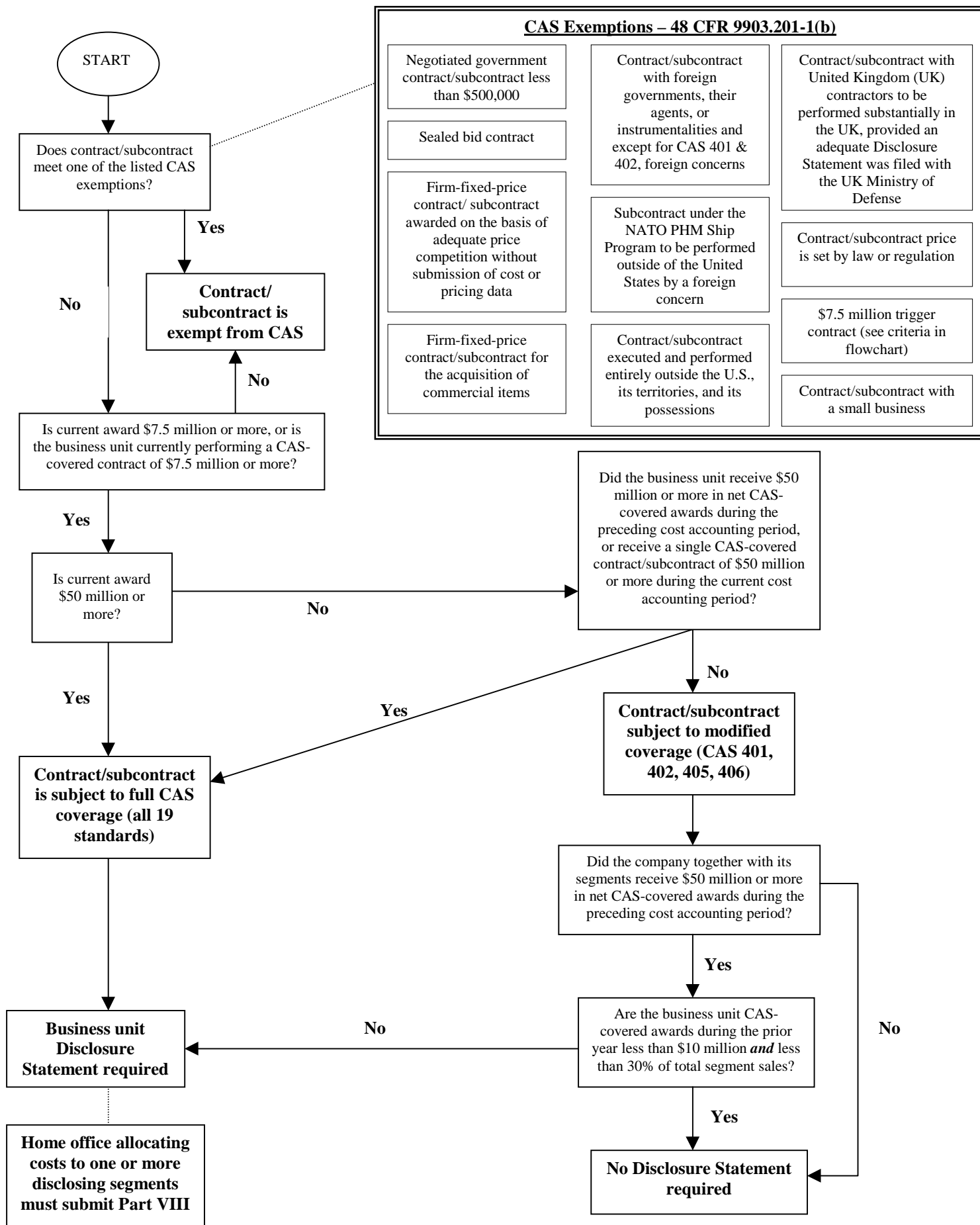
/s/

Lawrence P. Uhlfelder
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Enclosure

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CAS Coverage and Disclosure Statement Determination



Enclosure